



## Tax roulette challenged by Primakov

□ Boris Yeltsin's economic reforms crashed with the rouble in August 1998. This saw the return to favour of academic economists who proposed a radical tax reform which favours investment in productive activity instead of wheeling-dealing on the money markets.

□ By reducing profits taxes, Yevgeny Primakov's government hopes to end the flight of capital: \$60 billion disappeared into foreign banks between 1996 and 1998. But the IMF criticises the plan to reduce VAT, and is holding back on the loans it offered last summer.

□ Will Primakov's gamble pay off? Yes, says economics professor NICOLAUS TIDEMAN. Shifting taxes on to land and natural resources is a formula for relaunching the Russian economy. It would encourage people to work and save - and penalise the land speculators.

**T**HE TAX REFORM proposed by the Primakov government will increase gross domestic product by \$24.7 billion, or 5.3% in 2001. This is because the taxes for which rate reductions are planned are harmful, while the charges for which rate increases are planned are beneficial. Economically harmful taxes entice people to produce less.

A property tax is a combination of a harmful tax (a tax on structures) and a beneficial one (a tax on land). Taxing structures induces people to build fewer structures and to cut back on the maintenance. A tax on land is not harmful because the quantity of land cannot be reduced. Furthermore, taxing land reduces the profit from land speculation. So when land taxes are increased, the economy benefits from the use of land that would otherwise be held speculatively.

The tax reform proposed in Russia on December 16 involves reducing the profits tax, the payroll tax, and the value added tax, and increasing the taxes on land and natural resources, which are beneficial or at least potentially beneficial taxes.

Measuring the impact is a complex challenge, partly because the net effect on revenue is uncertain. If government revenue falls while spending remains unchanged, it is possible that more money will be printed, leading to additional inflation.

Government revenue depends on the mix of taxes, the output of the economy, and the extent of tax compliance. It may be possible to secure greater tax compliance, but one of the consequences will be reduced incentives to produce. Widespread tax cheating imposes special costs. When widespread, only those who are willing and able to cheat are able to survive in business. This limits the field of potential business owners. I have not undertaken a quantitative analysis of these complexities.

I have analyzed the proposed changes in tax rates as if they were the taxes that people will actually pay. I assume that, as of January 1, 1999, the following tax changes will occur:

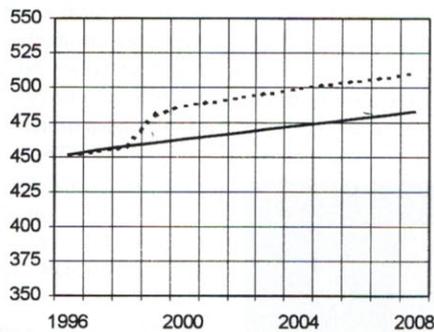
- ◆ Profits tax will fall from 35% to 30%.
- ◆ Value-added tax will fall from 20% to 15%, and to 10% a year later.
- ◆ Payroll tax will fall from 39.5% to 31.5%.
- ◆ Land taxes will double from 2% to 4%, and natural resource taxes will double as well.

Based on published data, I assume that

land and natural resource taxes currently take 9.47% of the income from these assets. I assume that the property tax takes 4.84% of asset income and will remain unchanged. I assume that excise taxes take 5.85% of personal income, that customs duties take 1.56% of personal income, and that these tax rates will remain unchanged. I estimate that the average recipient of labour income pays an income tax rate of 16.8% on an additional dollar of income, while the average recipient of income from land or capital pays a rate of 31.8% on an additional dollar of income. I also assume that special incentives for investment shelter one-third of the income from new investments, from profits taxes, property taxes, and income taxes.

**T**O ESTIMATE the economic consequences, I combine the taxes to determine the typical percentage of an additional dollar of income that goes to taxes (the marginal tax rate). I do this separately for labour income, capital income, and income from the possession of land. I also take note of the total tax rate on holding land, as a percentage of the income from land.

**The Effect of Tax Reform on Output  
(Billions of Dollars)**



When the tax reform is complete, the overall marginal tax rate will have fallen from 68.6% to 67.3% for land income, from 51.6% to 45.1% for capital income, and from 50.6% to 43.1% for labour income. The tax on holding land will have increased from 14.3% to 23.8% of the income from land.

The increase in the tax on land and natural resources will make it more expensive for people to possess these resources without using them, resulting in the use of more land.

As a result of improving technology, wages will rise over time even without reform, and this will induce people to work slightly

more each year. But the reduction in taxes on labour income will have a much greater effect. I estimate that, by 2001, the amount of labour used in production will increase by 6.7%.

The reduction in taxes on capital income will induce people to save more. By 2001, the proposed tax reform will cause an 18.2% increase in the amount of saving. The amount of capital in the economy will increase over time because of saving, but it will increase more rapidly when people save more. The tax reform will cause the rate of growth of the capital stock to increase from 1.7% per year to 2.0%.

The projected effect on total output is shown in the figure. I estimate that in 2001, the gross domestic product of the Russian economy will be greater by \$24.7 billion, or 5.3% of what it would be without reform.

**T**HE INCREASE in output is not a true measure of the value of tax reform. It omits four consequences.

- ◆ To produce more, people must work harder, the cost of which must be subtracted. In 2001, this cost will be \$6.5 billion.
- ◆ Additional production will cause additional depreciation of capital (\$3.3 billion).
- ◆ The reduction in taxes on capital income increases the value that people receive from saving. This additional value (\$12.5 billion) must be included.
- ◆ It appears that the reform will result in a significant reduction in government revenue. It is possible that this apparent reduction will be offset by measures that produce improved tax compliance. Or it might be offset by a reduction in the size of the public sector. Or it might be offset by printing additional currency, with resulting inflation, or offset by some combination of these. I have not accounted for the cost of reduced government revenue.

These four consequences can be added together to form the "excess burden of taxation." This is a name that public finance economists give to the harm that is caused by taxation. The reduction in excess burden is a summary measure of the benefit of the proposed reform, apart from its effect in reducing government revenue. Combining my estimates of the effects of tax reform on output, work effort, depreciation, and the value of savings, I estimate that in 2001 the tax reform will reduce the excess burden of taxation by \$27.4 billion